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Bank of Finland

Monetary Policy

Global Interdependence Center

Central Banking Series: Helsinki

June 6, 2016 at House of the Estates

Growth and inflation outlook in the euro area

The uncertainties are in part economic …

<u>Europe</u>
Risk of deflation?

<u>Oil and other commodities</u>
Price developments

<u>United States</u>
Gradual normalisation of monetary policy?

<u>China</u>
Slowing of economic growth and structural change

<u>Emerging economies</u>
Condition of balance sheets
Commodity prices

… but it is difficult to assess the economic importance of some risks

<u>Europe</u>

BREXIT

Refugee situation

<u>Middle East</u>

Geopolitical risks

<u>Global</u>

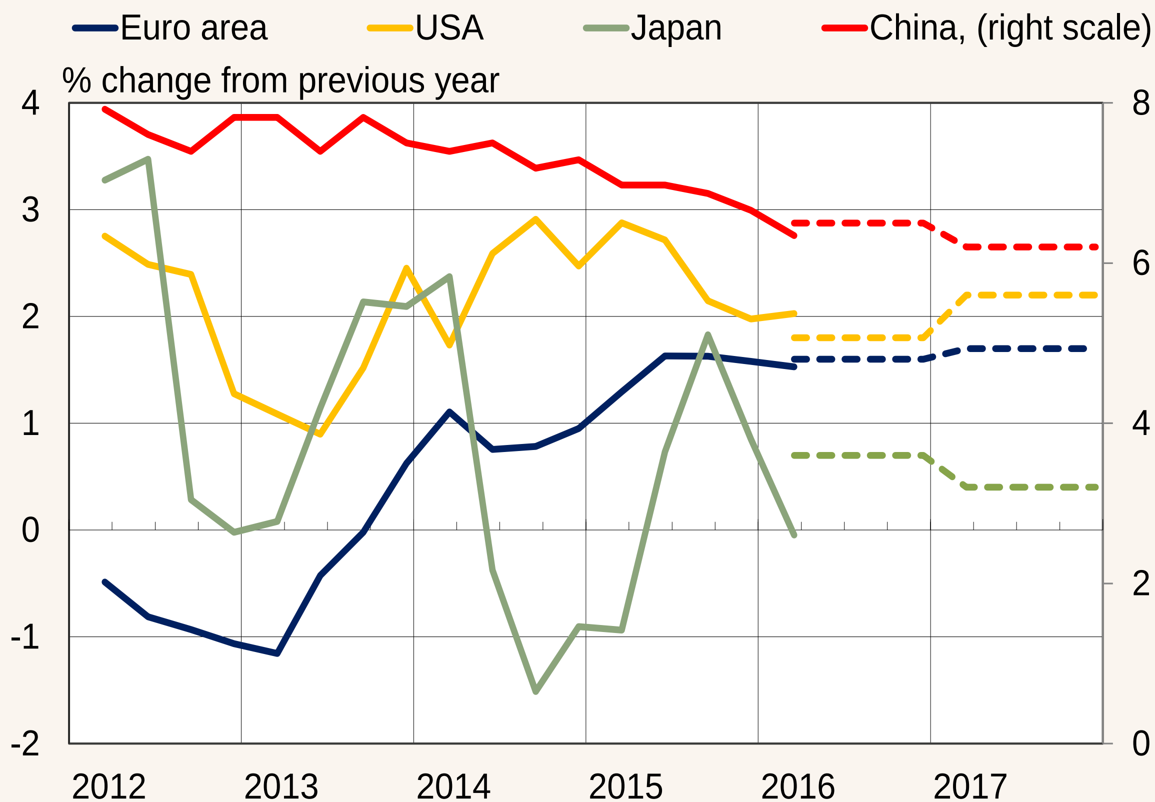
Consequences of climate change

<u>United States and Europe</u>

Opposition to free trade

Risk of introversion

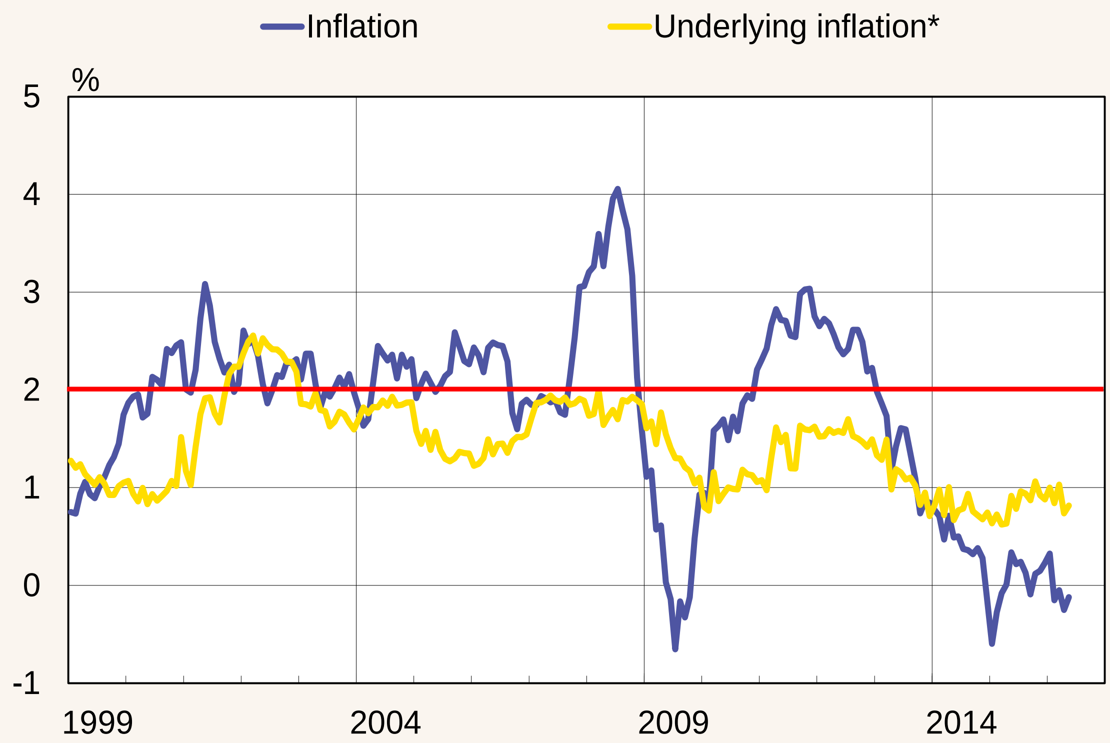
GDP recovery broad-based in the euro area



Sources: Eurostat, ECB and OECD.
Euro area ECB BMPE June 2016 projection. USA, Japan, China OECD June 2016 forecast. 32709

But consumer price inflation still subdued

Euro area consumer price inflation (HICP)



* Underlying inflation = inflation excluding energy, food, alcohol and tobacco.
Sources: ECB and Bank of Finland.
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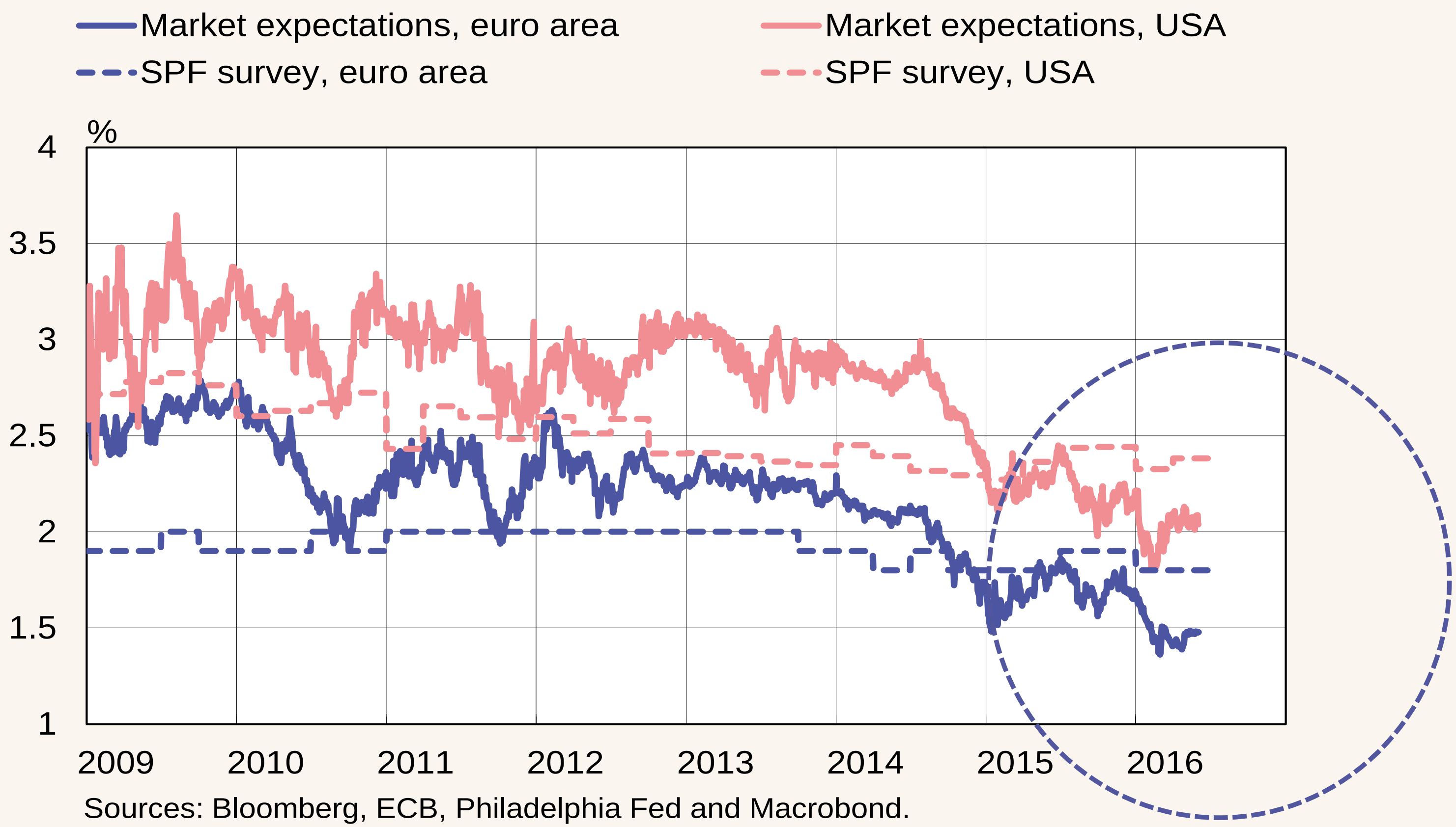
Long-term inflation expectations low in the euro area



Sources: Bloomberg, ECB, Philadelphia Fed and Macrobond.
Market expectations are based on 5-year and 10-year inflation-linked swap rates. The SPF survey horizon extends five years ahead.
patu32422@infoodotus(ENG)

Growth and inflation forecasts:
Eurosystem macroeconomic projections, June 2016

(change from March 2016 ECB staff macroeconomic projections)

- ***GDP:***
  - ***2016: 1.6% (+0.2%)***
  - ***2017: 1.7% (-)***
  - ***2018: 1.7% (-0.1%)***
- ***Inflation:***
  - ***2016: 0.2% (+0.1%)***
  - ***2017: 1.3% (-)***
  - ***2018: 1.6% (-)***

Monetary policy exceptionally accommodative for a prolonged period

Eurosystem non-standard monetary policy

- *Outright Monetary Transactions (2012-)*
- *Forward Guidance (2013-)*
- *Targeted Longer-term Refinancing Operations (2014-15 and 2016-17)*
- *Covered Bond Purchase Programme (2014-)*
- *Asset Backed Securities Purchase Programme (2014-)*
- *Public Sector Purchase Programme (2015-)*
- *Corporate Sector Purchase Programme (2016-)*

An important new step was taken in January 2015

- ***Expanded asset purchase programme***
  - ***<u>Bonds issued by euro area governments, government agencies and European institutions as a new target for purchases</u>***
  - ***Combined monthly asset purchases under the three programmes of EUR 60 billion from March 2015 until at least September 2016***

- ***Forward guidance***
  - ***<u>Purchases are intended to be carried out until end-September 2016 and will in any case be conducted until we see a sustained adjustment in the path of inflation consistent with our inflation aim.</u>***

Monetary policy was further eased on 10 March 2016 with the adoption of a comprehensive monetary policy package.

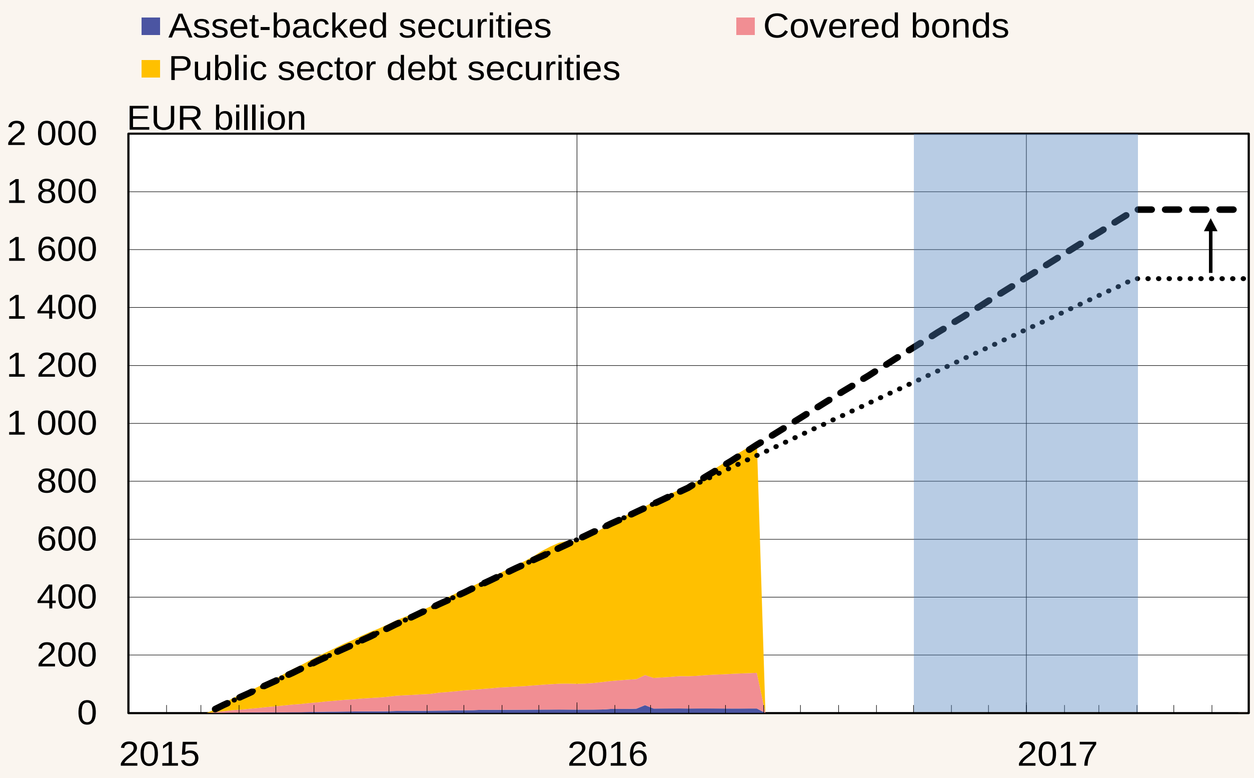
ECB Governing Council decisions in March 2016

- ***Monetary policy rates were lowered***
  - Key interest rate to **0.0%**
  - Deposit facility rate to **-0.40%**

- ***Monthly purchase volumes in the expanded asset purchase programme (EAPP) were expanded to €80 bn as of 1 April 2016***
  - Investment-grade bonds issued by non-banking-sector corporations included

- ***A second series of targeted longer-term refinancing operations (TLTRO 2) will be launched in June 2016.***
  - These will enhance the transmission of monetary policy measures to the economy by encouraging banks to increase lending to the real economy.
  - Each operation will have a 4-year maturity, and the interest rate can be as low as the rate on the deposit facility.

Monthly purchase volumes increased from EUR 60 billion to EUR 80 billion



Sources: ECB and Macrobond.

The dashed line shows target path announced in March, the dotted line shows the previous target path announced in December 2015.

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ECB Governing Council on 2 June 2016 confirmed its forward guidance on monetary policy

- ***Purchases are intended to run until <u>at least the end of March 2017, or beyond, if necessary</u>, until inflation is on a sustained path towards a level below, but close to, 2%***.

- ***In view of the current outlook for price stability, the Governing Council expects the key ECB interest rates to remain at <u>present or lower levels for an extended period of time, and well past the horizon of the asset purchases</u>***.

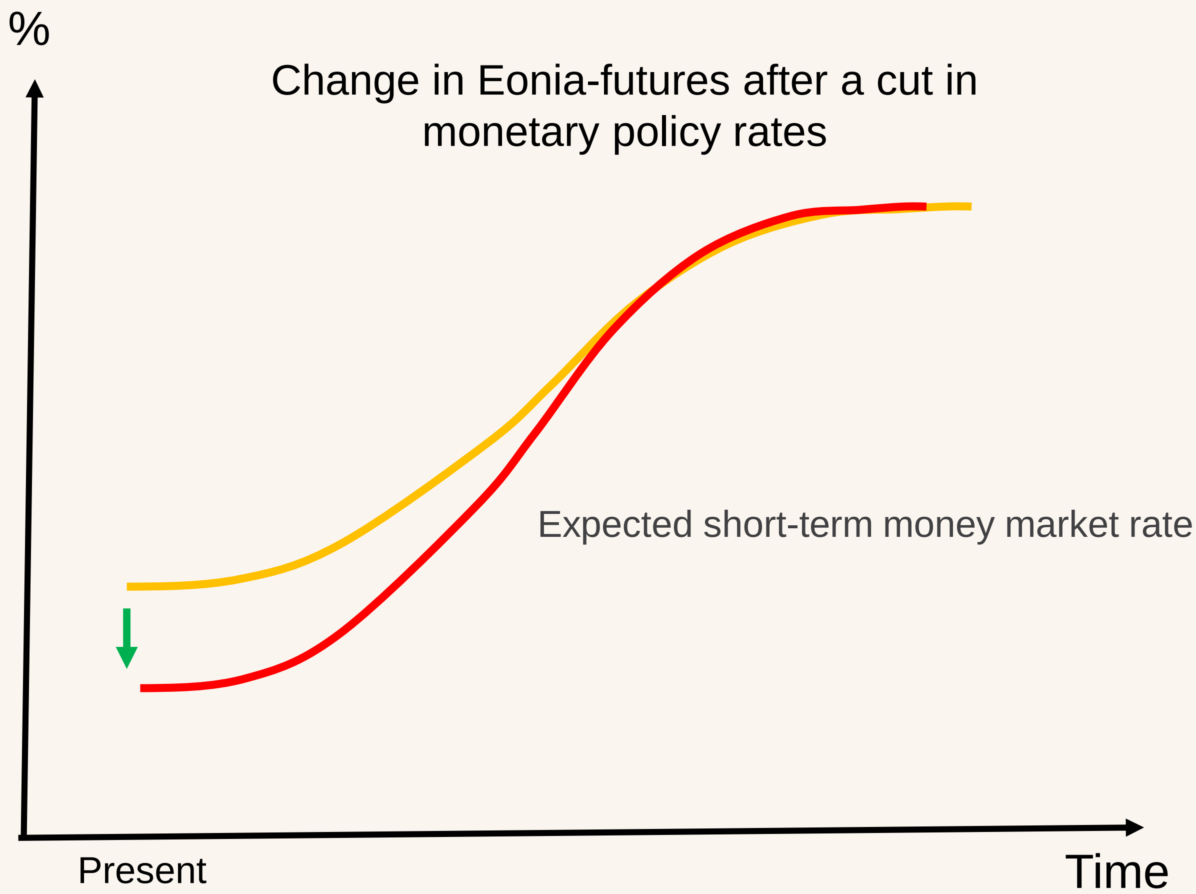
ECB Governing Council on 2 June 2016

- ***In the current context, it is crucial to ensure that the very low inflation <u>environment does not become entrenched in second-round effects on wage and price setting.</u>***

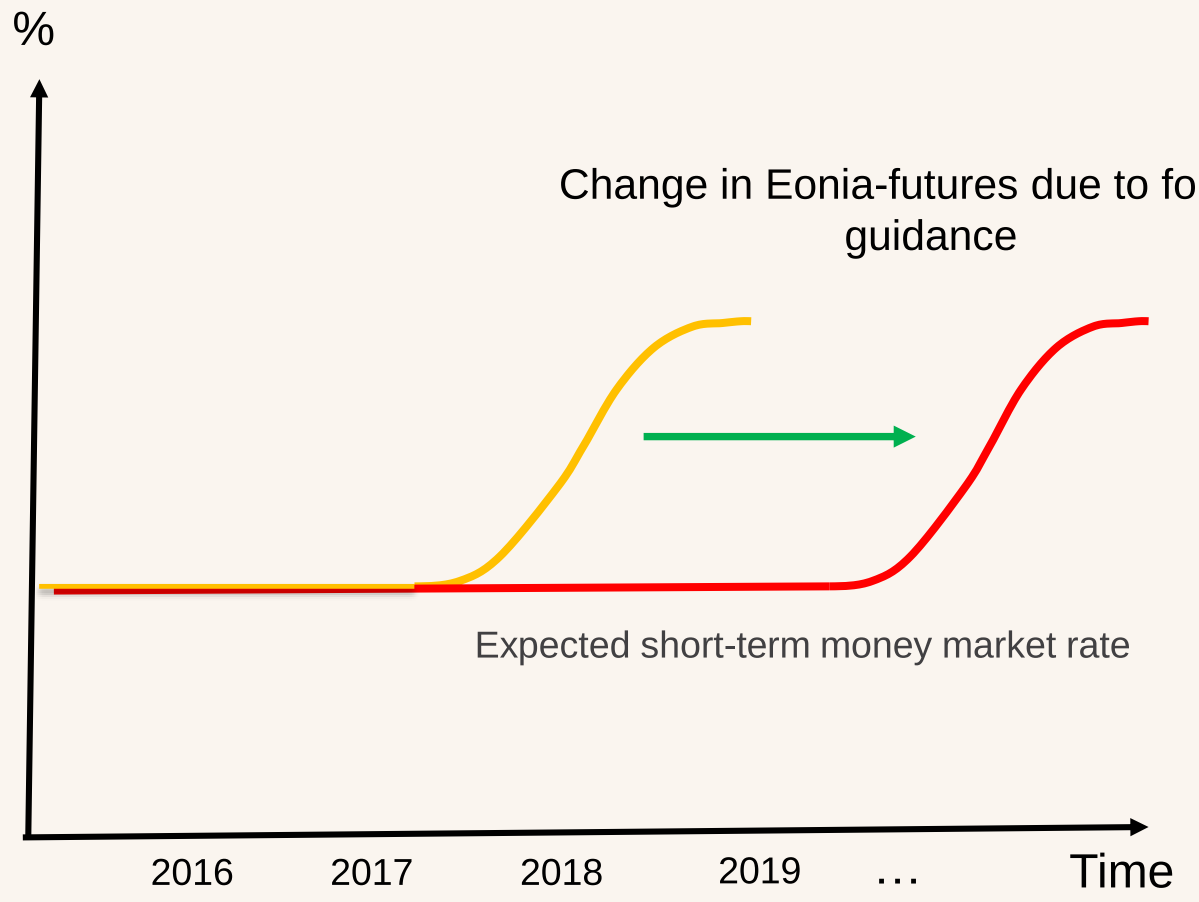
- ***The Governing Council <u>will closely monitor</u> the evolution of the outlook for price stability and, <u>if warranted to achieve its objective, will act by using all the instruments available within its mandate.</u>***

Monetary policy transmission channels

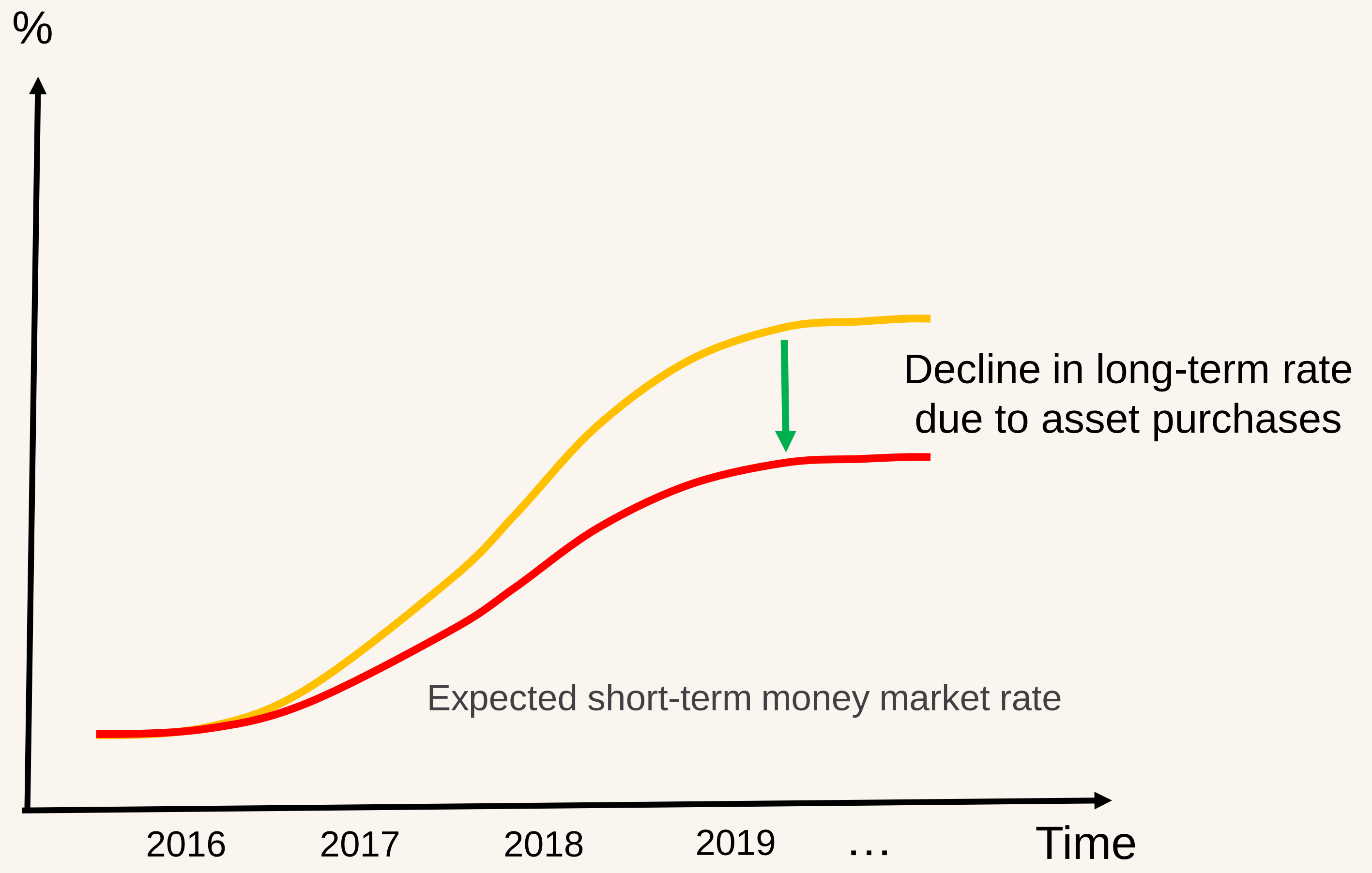
A cut in <u>monetary policy rates</u> lowers short-term money market rates…



… *forward guidance* postpones expected tightening of monetary policy…



… and asset purchases depress long-term interest rates



Negative deposit rates

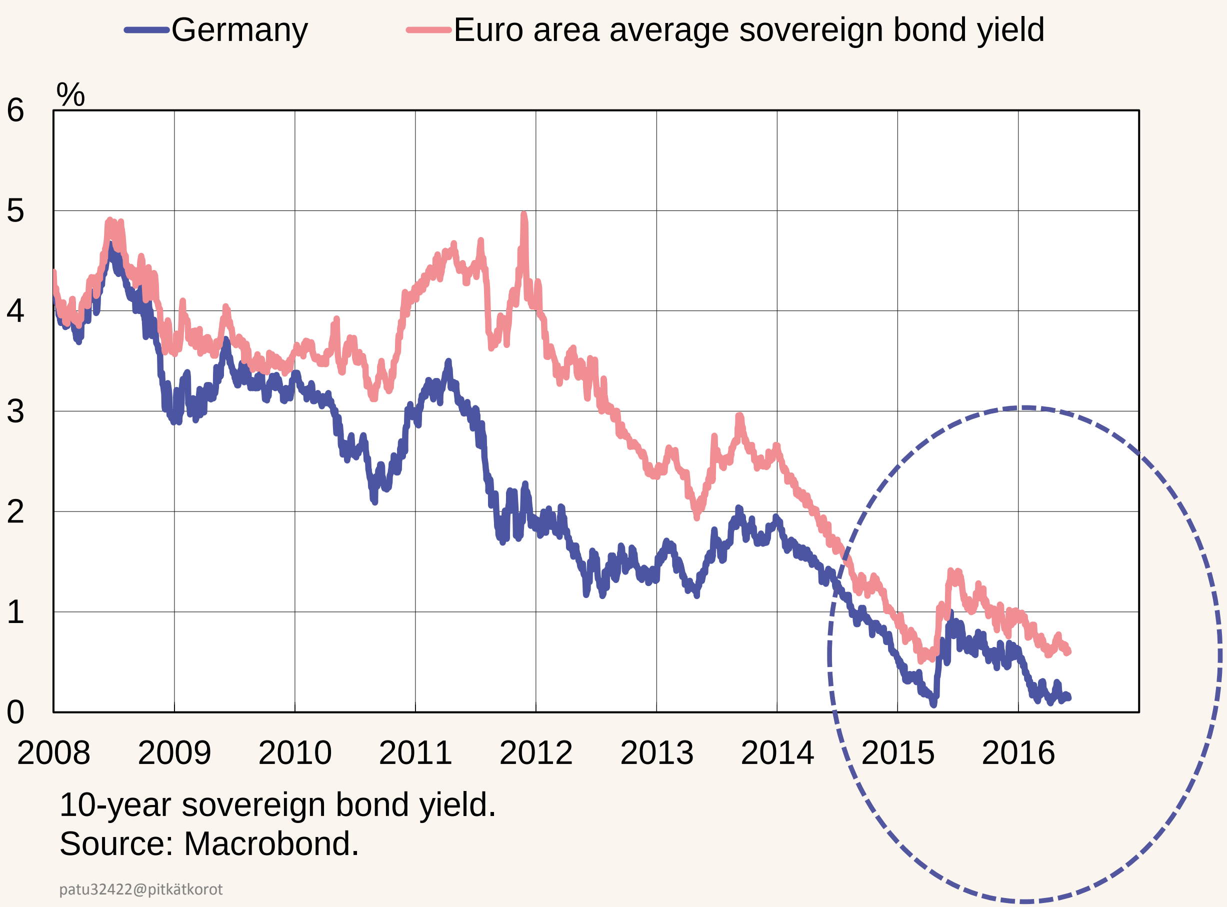
- ***The Governing Council of the ECB introduced negative deposit rate in June 2014, with three further reductions in September 2014, December 2015 and March of this year.***
  - ***In March the deposit rate was lowered to -0,4 %.***
- ***The main objectives of this measure are twofold:***
  - ***to further lower money market rates and the longer end of the yield curve via expectations effects***
  - ***to increase the velocity of circulation of excess reserves in the interbank market towards banks that need liquidity to sustain or expand their credit portfolios***

Channels of influence of a more accommodative monetary policy

- ***Lowers real interest rates and eases financial conditions in the economy***
  - *interest rates at the longer end decline, financial conditions for companies and households become easier, securities prices rise*
  - *higher inflation expectations mean lower real interest rates*
  - *corporate and household confidence improves*

- ***Increases demand and boosts inflation***
  - *consumption and profitability of investments increase*
  - *external value of the euro depreciates*

Euro area sovereign bond yields at low levels



10-year sovereign bond yield.
Source: Macrobond.

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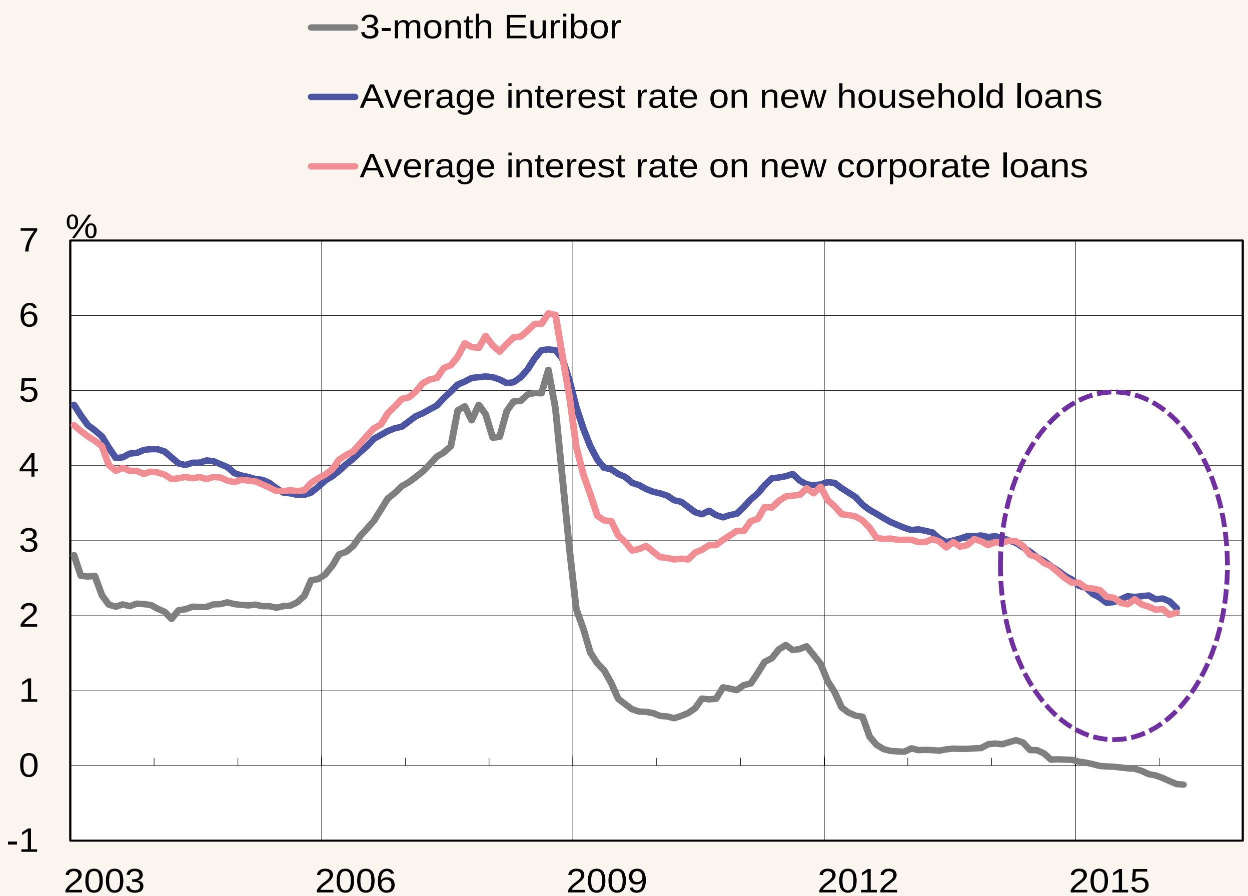
Bank lending rates on household and corporate loans have decreased



Sources: ECB and Macrobond.

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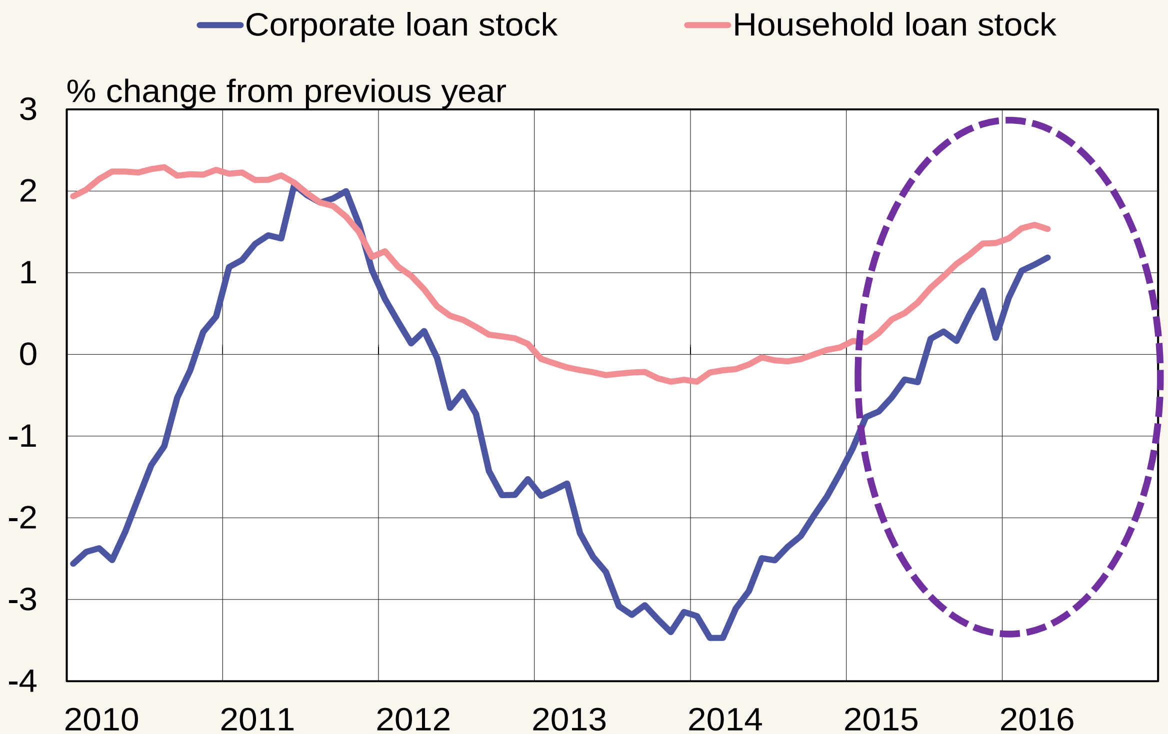
Growth in bank loans has accelerated

Annual growth in loan stocks



Loan stocks adjusted for balance sheet transfers and securitisation.
Sources: ECB and Macrobond.
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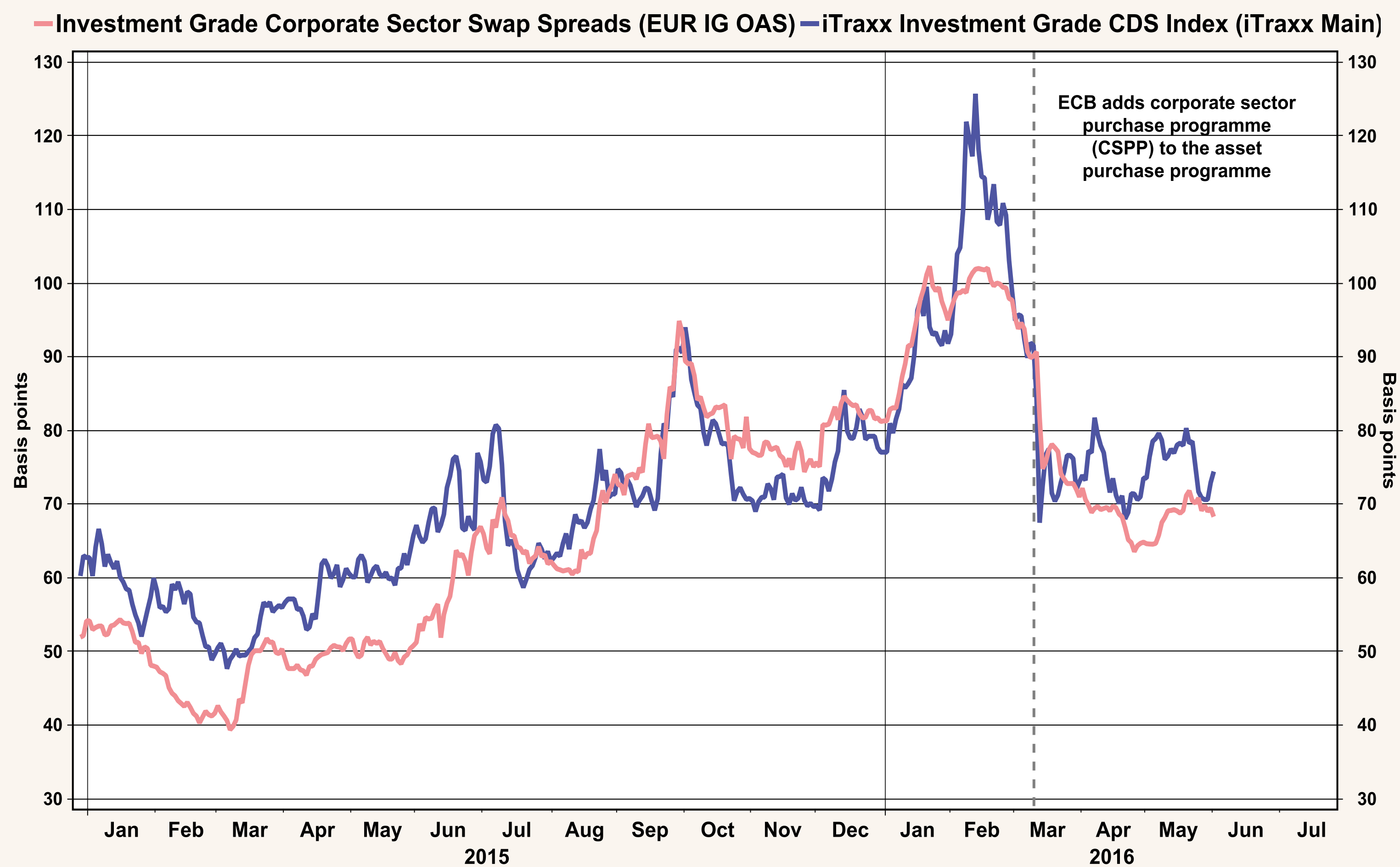
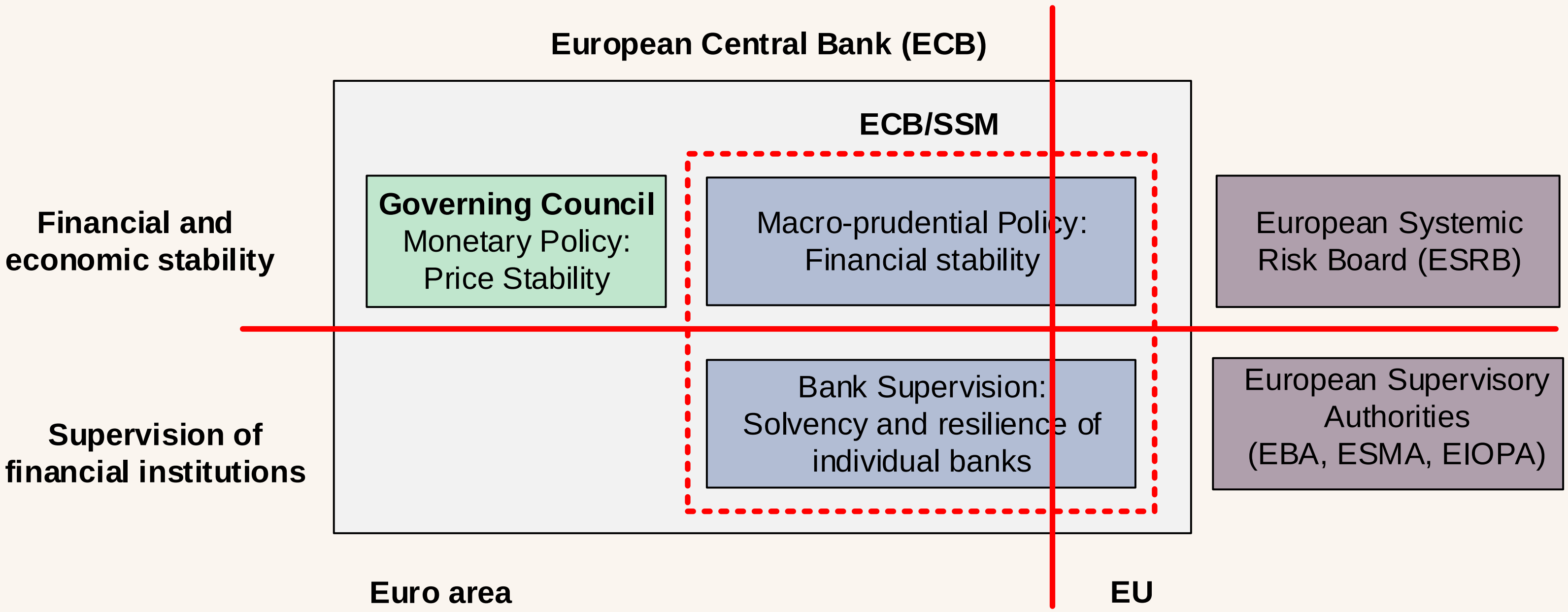
Corporate bond spreads have declined



Source: Bloomberg

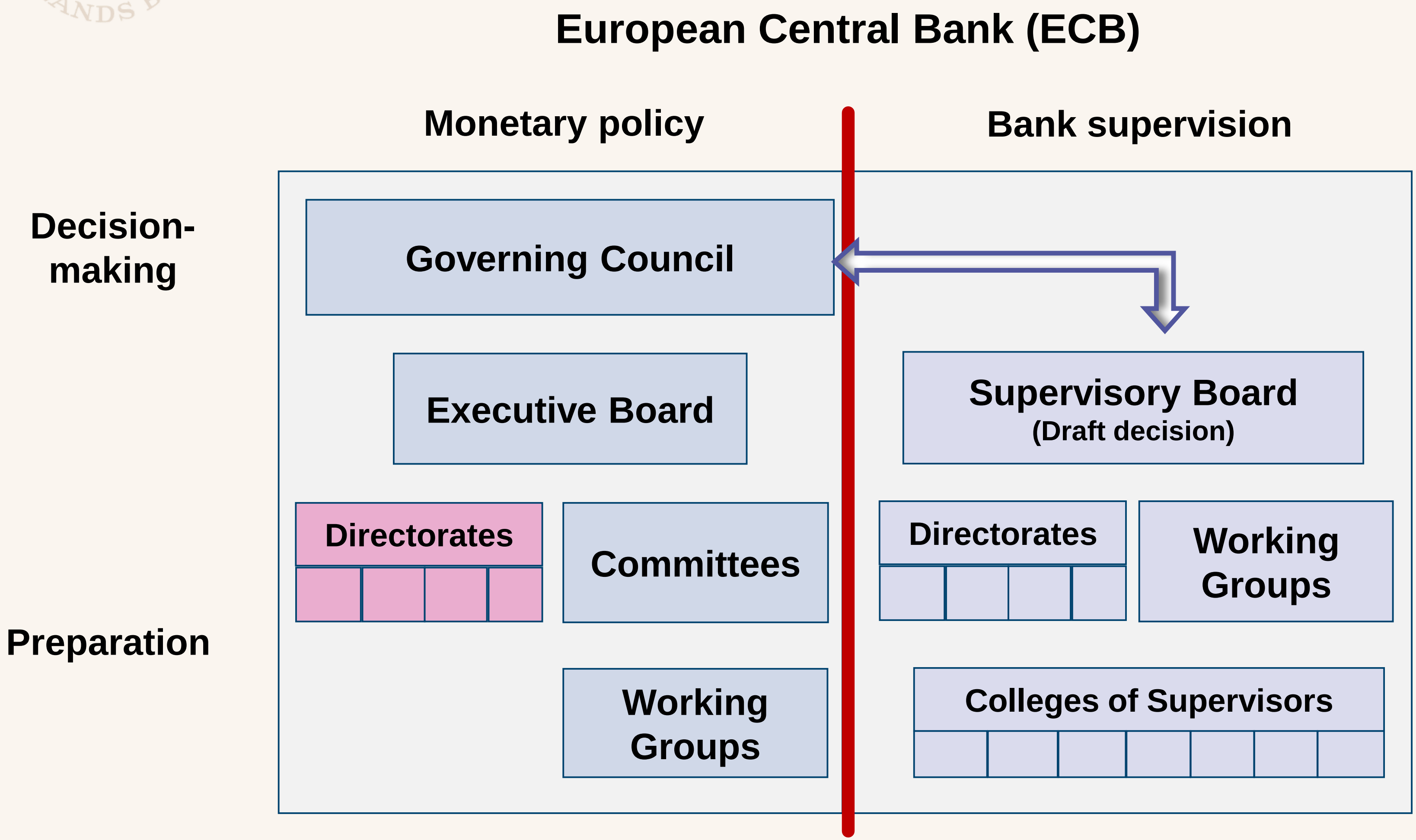
On the Banking Union and the new responsibilities of the ECB

ECB's role in the new supervisory architecture



Sources: Smets (2013) and Bank of Finland.

ECB´s monetary policy and bank supervision separated



ECB reinforces but cannot substitute for national macroprudential policies in the euro area

- ***National macroprudential authorities bear the main responsibility for detecting systemic risks and taking appropriate macroprudential action***
- ***National macroprudential action should be timely, bold and intrusive***
- ***The ECB can reduce the inaction bias inherent in national macroprudential policies***
- ***European Systemic Risk Board (ESRB) provides EU-level guidance to prevent and mitigate systemic risks***

European Systemic Risk Board (ESRB) oversees the EU financial system

- *In response to the global financial crisis, the ESRB was established as a Union-level body to prevent and mitigate systemic risks*
- *The ESRB monitors and assesses systemic risks, collecting views of both central bankers and supervisory authorities*
- *To pursue its macroprudential mandate, the ESRB may issue risk warnings and policy recommendations*

Two main groups of macroprudential tools

- ***1) Tools directed (mainly) at financial institutions:***
  - ***Countercyclical Capital Buffer***
  - ***Capital buffers for Systemically Important Financial Institutions***

- ***2) ”Borrower-based tools”: tools directed (mainly) at borrowers and terms and conditions of loans:***
  - ***Loan-to-value cap , Loan-to-income cap, Debt-service-to-income cap, Amortisation requirements,…***

- ***In several countries, borrower-based tools automatically apply to loans made by branches of foreign banks***

New financial regulatory architecture and monetary policy transmission

The mandate of the ECB

- ***Maintaining price stability** is the **primary objective** of the ECB.*
- ***Without prejudice to price stability, the ECB shall support the general economic policies in the EU, including balanced economic growth.***
- ***Financial stability** is key to realizing this mandate.*
- ***The SSM regulation assigns macroprudential responsibilities to the ECB, with power to apply tighter macroprudential requirements than the designated national macroprudential authorities.***

New financial regulatory architecture and monetary policy transmission

- ***Monetary policy transmission more immune from disruption***
  - *Banks more resilient to future shocks*
  - *New macroprudential instruments designed to improve the stability of the financial system as a whole*
- ***Interaction of micro- and macroprudential policy can enhance the effectiveness and efficiency of monetary policy***
  - *Effective regulation protects monetary policy from financial dominance*
- ***Euro area less vulnerable to fragmentation***
  - *The SSM creates the conditions and incentives for deeper integration of the European banking market*

Thank you!